Tax Changes Create New Estate & Gift Planning Opportunities

1/20/2011
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A new federal law includes many changes in estate, gift and generation-skipping transfer (GST) taxes that may be of interest to you. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, signed into law on December 17, 2010, includes:

- Lower tax rates
- Higher estate, gift and GST tax exemptions
- Portability, which is the ability of a surviving spouse to utilize that portion of the estate and gift tax exemption that was not utilized by the deceased spouse

However, the tax relief is temporary and will expire after 2012. On January 1, 2013, less favorable tax rules, similar to those that were to take effect prior to the passage of the new Tax Relief Act, are scheduled to apply.

The following is a summary of the estate, gift and GST tax changes that are included in the Act.

Estate tax changes: For 2011 and 2012, the Tax Relief Act reduces the top estate tax rate to 35 percent. It also increases the estate tax exemption to $5 million for 2011 and 2012 (indexed for inflation in 2012), which means that a person dying in 2011 or 2012 will generally be able to protect up to $5 million in assets from estate taxation. However, after 2012 the top estate tax rate is scheduled to be 55 percent, and the estate tax exemption is scheduled to be $1 million.

Estate tax savings choice for 2010: The Tax Relief Act allows estates of those who died in 2010 to choose between:

1. Estate tax (with a $5 million exemption and 35 percent top estate tax rate) and a fresh income tax basis for assets that pass to the decedent's heirs; or
2. No estate tax and modified carryover income tax basis for assets that pass to the decedent's heirs

The term "basis" is the yardstick for measuring income tax gain or loss when an asset is sold. With a fresh basis, pre-death gain or loss is eliminated because, in the hands of the heir, the basis is changed to the date of death value of the asset. On the other hand, with a modified carryover basis, an heir generally inherits the decedent’s basis in the assets, but not to exceed the date of death values of the assets, plus certain increases, which can be substantial.

The decedent's personal representative should analyze the choices to determine which would produce the lowest combined estate and income taxes. This would depend, among other factors, on the decedent's income tax basis in the assets immediately before death and how soon the estate beneficiaries may sell the assets after the death.

Gift tax changes: Several years ago, the gift tax and the estate tax shared a single tax exemption and were subject to the same tax rates. This was not the case in recent years. For gifts made in 2011 and 2012, the gift tax and estate tax are reunified, and an overall $5 million tax exemption and 35 percent top rate apply.

GST tax changes: In general, the GST tax is an additional tax on gifts and bequests to grandchildren and lower-generation beneficiaries. The Tax Relief Act lowers GST taxes for 2011 and 2012 by increasing the GST tax exemption amount from $1 million to $5 million (indexed for inflation in 2012) and reducing the GST tax rate from 55 percent to 35 percent.

New portability feature: Any portion of the $5 million estate and gift tax exemption that remains unused as of the death of a spouse in 2011 or 2012 is generally available for use by the surviving spouse (in addition to the surviving spouse's own $5 million exemption) during life or at death. While the new portability rule may make setting up trusts for each spouse unnecessary to minimize estate taxes in some cases, there are still many other reasons to employ trusts for each spouse. They include:

- Trusts can shelter from estate tax any appreciation occurring between the death of the first spouse and the death of the second spouse.
- Trusts protect assets from creditors of the surviving spouse or other heirs, and provide greater management of assets for heirs.
- Trusts may prevent the tax exemption that was transferred to the surviving spouse (under the new portability rule) from being lost in the event the surviving spouse remarries and is again widowed.
- Trusts enable each spouse to fully utilize his/her GST tax exemption, as the GST tax exemption is not portable under the new law.
- Trusts can prevent unwanted changes in the decedent's estate plan by the surviving spouse.
- Trusts enable each spouse to utilize his/her estate and GST tax exemptions to the fullest extent (assuming the new portability feature is not continued after 2012).

Conclusion: Although the Act provides substantial tax relief, estate planning to reduce taxes, protect assets, maximize use of the GST tax exemption and provide for the management of assets is still very important. The Act provides many new planning opportunities for lifetime giving and passing a greater amount of wealth without incurring gift, estate or GST taxes. But the provisions of the new law are temporary so the window of opportunity may be available for only two years. Even if taxes are not a concern because an estate is below the exemption levels, it is still very important to have a proper estate plan to ensure that your desires for the management, protection and distribution of your assets are carried out.

Please contact your Warner Norcross & Judd estate planning attorney if you want to discuss planning opportunities in more detail, or Susan Meyers (616.752.2184 or smeyers@wnj.com) or Frank Henke (248.784.5008 or fhenke@wnj.com).